

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
FARID NAIB AND REBECCA MALCOLM-NAIB	:	DETERMINATION
		DTA NO. 819695
for Redetermination of a Deficiency or for Refund of New York State and New York City Personal Income Tax under Article 22 of the Tax Law and the Administrative Code of the City of New York for the Year 1998.	:	

Petitioners, Farid Naib and Rebecca Malcolm-Naib, 38 Harrison Drive, Newton Square, Pennsylvania 19073-1422, filed a petition for redetermination of a deficiency or for refund of New York State and New York City personal income tax under Article 22 of the Tax Law and the Administrative Code of the City of New York for the year 1998.

A hearing was held before Timothy J. Alston, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on May 20, 2004 at 10:30 A.M., with all briefs to be submitted by August 19, 2004, which date began the six-month period for the issuance of this determination. Petitioners appeared by Samir A. Naib, CPA. The Division of Taxation appeared by Christopher C. O'Brien, Esq. (Margaret T. Neri, Esq., of counsel).

ISSUE

Whether nonresident-petitioner Farid Naib has established that he purchased certain stock options and thereby established that certain income, reported as ordinary income on petitioners' originally-filed return, is properly classified as capital gain and is not allocable to New York for personal income tax purposes.

FINDINGS OF FACT

1. Petitioners, Farid Naib and Rebecca Malcolm-Naib, were residents of Pennsylvania in 1998. Petitioner Farid Naib¹ was the majority shareholder and an employee of FNX, Ltd. (“FNX”), a software development company with headquarters in Pennsylvania. FNX also had an office in New York City in 1998. Petitioner occasionally worked in New York in 1998.

2. Petitioners jointly filed a New York nonresident income tax return for the year 1998 on or about July 8, 1999. Petitioners’ return reported \$1,810,247.00 in Federal wages and zero in New York wages. FNX issued a W-2 form to petitioner Farid Naib which reported wages of \$1,810,247.00.

3. During the course of an audit of petitioners’ 1998 return, but prior to the issuance of any statutory notice, petitioners filed an amended nonresident return in October 2001 which reported \$835,902.00 in Federal wage and salary income and allocated \$113,435.00 in wage and salary income to New York.

4. The reduction in Federal wage income on the amended return resulted from a reclassification of \$974,345.00 in income previously reported as wages and salary to capital gain income.

5. The allocation of \$113,435.00 in wages and salary to New York on the amended return resulted from petitioner’s reporting of 34 days worked in New York out of 243 days worked in the year.

6. Petitioners also filed an amended Federal income tax return for 1998 in October 2001. Similar to their amended New York return, petitioners reclassified \$974,345.00 in income

¹ At issue in this matter is the proper classification of certain income earned by petitioner Farid Naib. Accordingly, all references to “petitioner” herein (unless otherwise indicated) shall refer to Farid Naib.

previously reported as wages to capital gain income on their amended Federal return. As a result of this change (and other relatively minor changes), petitioners' total Federal tax liability decreased by \$77,939.00.

7. The amended Federal return contains the following explanation for the reclassification of income:

Taxpayer purchased 65,075 options in the company as an investment. Taxpayer was also granted options by the company. The company incorrectly treated the total proceeds paid out in 1998 for the options as compensation. \$974,345 (\$1,315,989 proceeds less \$341,633 cost) related to the 65,075 options represents a capital transaction.

8. In connection with petitioners' reclassification of income from wages to capital gain, petitioners' amended Federal return includes an amended schedule D-1 Part II ("Long-Term Capital Gains and Losses-Assets Held More Than One Year"). In addition to the long-term capital gains and losses previously listed on petitioners' original return, the amended schedule D-1 reports a sale of "FNX Stock Options" acquired February 1, 1997 and sold December 31, 1998 at a sales price of \$1,315,989.00. The amended schedule D-1 further reports a cost basis of \$341,644.00 for such options and a resulting gain of \$974,345.00.

9. Following the filing of the amended Federal return, the Internal Revenue Service sent a notice to petitioners dated February 4, 2002 advising petitioners that "[a]s you requested, we changed your account for 1998 to correct your tax credits, schedule D and schedule A." This notice further noted a decrease in tax because of this change of \$77,939.00.

10. At the conclusion of its audit, the Division of Taxation issued to petitioners a Notice of Deficiency dated September 5, 2002 which asserted \$26,530.45 in additional New York State

and City income tax due, plus penalty and interest, for the year 1998.² In its calculation of the deficiency, the Division used the \$1,810,247.00 amount reported as wage and salary income from FNX on petitioners' original New York and Federal returns as the starting point in determining petitioners' New York source income.

11. Following a Bureau of Conciliation and Mediation Services ("BCMS") conciliation conference on March 4, 2003, BCMS issued a conciliation order to petitioners dated July 11, 2003 which modified the tax assessed in the subject notice to \$14,356.71 in New York State income tax due, plus interest. The conciliation order canceled the New York City income tax and penalties asserted in the statutory notice. This modified deficiency also used Farid Naib's \$1,810,247.00 FNX compensation as reported on the original returns as the starting point in determining petitioners' New York source income. In calculating this deficiency, the Division accepted petitioner's allocation percentage of 34 days worked in New York out of 243 days worked in the year as reported on the amended nonresident return. Based upon this allocation percentage, the Division determined New York source income of \$249,746.00 and, after allowing for reported New York schedule D and schedule E losses, New York adjusted gross income of \$210,309.00. The Division then calculated petitioners' New York source fraction by dividing New York adjusted gross income by Federal adjusted gross income of \$4,431,833 as reported on petitioners' amended Federal return and applied the result, 4.75 percent, to petitioners' base tax of \$302,246.45 to reach New York tax due of \$14,356.71.

12. FNX issued two promissory notes, each dated December 1, 1995 and each in the amount of \$182,500.00, to two of its employees, Kevin Horio and Thomas Chiang. The notes

² On January 2, 2002 petitioners consented to an extension of the period of limitations for assessment until October 15, 2002 for the 1998 tax year.

provided that each was issued “pursuant to the Option Cancellation and Amendment Agreement dated as of the date hereof between the Company [FNX] and the Holder and is subject to the terms and conditions contained therein.” No such Option Cancellation and Amendment Agreement is in the record herein.

13. The December 1, 1995 promissory notes were payable in six equal monthly installments from January 15, 1996 through June 14, 1996. Payroll records show that FNX made the payments to the note holders accordingly

14. Petitioner Farid Naib executed a promissory note in favor of FNX dated December 31, 1996 in the amount of \$203,031.00 payable in (approximately) bi-weekly installments of \$1,500.00 commencing January 15, 1997 with all remaining principal and interest due June 30, 1997.

15. FNX payroll records indicate that petitioner made loan repayments through payroll deductions for the year 1997 totaling \$68,569.76. Other FNX payroll records indicate that petitioner made loan repayments totaling \$34,069.76 during the year 1997. There is no explanation in the record as to which of these totals purportedly represent payments pursuant to the promissory note dated December 31, 1996. In addition, FNX payroll records show that petitioner made a loan repayment of \$1,500.00 through a payroll deduction for the period December 16, 1997 through December 31, 1997.

16. Petitioner submitted a letter dated May 15, 2003 from Phillip Bell, president of FNX, to petitioners’ representative. With respect to the December 1, 1995 notes payable to Horio and Chiang the letter stated:

As you are aware, these notes were entered into with these individuals by FNX on behalf of Farid Naib. Farid was obligated to reimburse FNX for these expenditures. The Promissory Note Receivable dated December 31, 1996, sent

earlier, between FNX and Farid Naib represents the remaining amount due FNX from Mr. Naib as of that date.

17. Petitioner also submitted a notarized statement³ from Kevin Horio dated May 14, 2004 which provided:

I Kevin Horio certify that on December 1, 1995, I sold my stock options in FNX Limited (a subchapter S corporation) to Farid A. Naib, majority owner of FNX Limited, in exchange for a non-negotiable note in the amount of \$182,500 which was paid in full by June 14, 1996.

SUMMARY OF PETITIONERS' POSITION

18. Petitioner contends that he purchased and sold FNX stock options as reported on schedule D-1 Part II of his amended Federal return (*see*, Finding of Fact “8”) and that the resulting gain of \$974,345.00 as reported on the amended return was improperly included on petitioner’s W-2 and on his original Federal and New York nonresident returns as ordinary wage income. Specifically, petitioner asserts that he purchased FNX stock options from Kevin Horio and Thomas Chiang and borrowed funds from FNX to finance the purchase. Accordingly, petitioner asserts that his wage and salary income in 1998 subject to New York personal income tax (in accordance with his income allocation percentage) was \$835,902.00 as reported on the amended State and Federal returns and not \$1,810,247.00 as reported on the original New York nonresident return, original Federal return and W-2 issued by FNX.

CONCLUSIONS OF LAW

A. Nonresidents of New York, such as petitioners, are subject to income tax by New York only on such income as is “derived from or connected with New York sources” (Tax Law § 631[a]), including compensation income that is “attributable to . . . a business, trade, profession or occupation carried on in this state” (Tax Law § 631[b][1]). Compensation income earned by a

³ Although petitioner referred to this statement as an affidavit, it is unsworn and thus not an affidavit.

nonresident is, generally, allocated between business conducted in New York and business conducted elsewhere based on the number of days worked within and without New York and is subjected to tax by New York accordingly (Tax Law § 631[c]; 20 NYCRR 132.18). Income from intangible personal property, such as stocks and stock options, constitutes income derived from New York sources “only to the extent that such income is from property employed in a business, trade, profession, or occupation carried on in this state” (Tax Law § 631[b][2]). Where a nonresident who works in New York receives compensatory stock options from his or her employer, such options are compensation attributable to a “business, trade, profession or occupation carried on” in New York and properly subject to New York personal income tax in accordance with that taxpayer’s income allocation percentage (*see, Matter of Michaelson v. New York State Tax Commission*, 67 NY2d 579, 505 NYS2d 585). In contrast, where the same nonresident purchases stock options at fair market value, such options are capital assets unconnected with New York sources and thus not subject to New York income tax.

B. Tax Law § 689(e) places the burden of proof on petitioner to show by clear and convincing evidence that the deficiency issued by the Division is erroneous (*see, Matter of Suburban Restoration Co., Inc. v. Tax Appeals Tribunal* 299 AD2d 571, 750 NYS2d 359). Thus, to prevail in the instant matter petitioner must show that he purchased stock options at fair market value and thereby properly reclassified \$974,345.00 in income from ordinary wage and salary income to capital gain as reported on the amended returns.

Petitioner has failed to meet his burden. Petitioner’s case depends upon establishing that he purchased FNX stock options from Kevin Horio and Thomas Chiang. The record, however, contains no contemporaneous documentation of this claimed purchase of options at a purported price of \$341,644.00 (*see*, Finding of Fact “8”). Moreover, the documents in the record offer

little support to petitioner's claim. Specifically, the promissory notes dated December 1, 1995 made by FNX and held by Horio and Chiang reference an option cancellation agreement (also absent from the record). These documents do not in any way suggest a sale of options to petitioner. Additionally, the promissory note from petitioner to FNX contains no reference to any purchase of options by petitioner. Further, the dates of the various promissory notes are inconsistent with petitioner's claim that he purchased options from Horio and Chiang. The FNX notes held by Horio and Chiang are dated December 1, 1995, the promissory note from petitioner to FNX, by which he purportedly financed his acquisition of options, is dated December 31, 1996, yet the amended Federal return indicates an acquisition dated of February 1, 1997. Finally, the amounts of the various documents appear to be inconsistent as to the purported purchase price of the options. The amended schedule D-1 reports an acquisition price of \$341,644.00, while the notes to Horio and Chiang total \$365,000.00, and the note from petitioner to FNX, Ltd. is for \$203,031.00.

Given the absence of any contemporaneous documentation of the claimed sale and the absence of proof of the claimed sale provided by the documents in the record, petitioner's testimony that he purchased the options as claimed, the letter to petitioner's representative dated May 15, 2003 from the president of FNX (*see*, Finding of Fact "16"), and the unsworn statement of Kevin Horio (*see*, Finding of Fact "17") are properly given little weight herein.

C. The petition of Farid Naib and Rebecca Malcolm-Naib is denied and the Notice of Deficiency dated September 5, 2002, as modified pursuant to the Conciliation Order dated July 11, 2003 (*see*, Finding of Fact “11”), is sustained.

DATED: Troy, New York
February 3, 2005

/s/ Timothy J. Alston
ADMINISTRATIVE LAW JUDGE